

**SURREBUTTAL TESTIMONY OF**

**DANIEL F. SULLIVAN**

**ON BEHALF OF**

**THE SOUTH CAROLINA OFFICE OF REGULATORY STAFF**

**DOCKET NO. 2019-281-S**

**IN RE: APPLICATION OF PALMETTO UTILITIES, INC. FOR  
ADJUSTMENT (INCREASE) OF RATES AND CHARGES, TERMS AND  
CONDITIONS, FOR SEWER SERVICE PROVIDED TO CUSTOMERS IN  
ITS RICHLAND AND KERSHAW COUNTY SERVICE AREAS**

**Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS, AND OCCUPATION.**

**A.** My name is Daniel F. Sullivan. My business address is 1401 Main Street, Suite 900, Columbia, South Carolina 29201. I am employed by the State of South Carolina as the Deputy Director of the Audit Department for the Office of Regulatory Staff (“ORS”).

**Q. DID YOU FILE DIRECT TESTIMONY AND EXHIBITS RELATED TO THIS PROCEEDING?**

**A.** Yes. I filed direct testimony and two (2) exhibits with the Public Service Commission of South Carolina (“Commission”) on May 26, 2020. Subsequently, I filed revised direct testimony and two (2) revised exhibits on June 5, 2020.

**Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY IN THIS PROCEEDING?**

**A.** The purpose of my surrebuttal testimony is to respond to the rebuttal testimony filed by Palmetto Utilities, Inc. (“PUI” or “Company”) witness Daday on June 9, 2020, regarding the return to customers of the regulatory liability for the excess federal corporate income tax

expense embedded in rates charged to customers since January 1, 2018 due to the 2017 Tax Cuts and Jobs Act (“TCJA”). In addition, my surrebuttal testimony will respond to two adjustments addressed by Company witness Daday that were originally discussed in the direct testimony of ORS witness Seale. Specifically, I will focus on:

- ORS Adjustment 2D – Miscellaneous Expenses – Bonuses
- ORS Adjustment 4 – Rate Case Expenses

**Q. PLEASE RESPOND TO THE ASSERTIONS MADE BY PUI ABOUT ORS STAFF’S CONDUCT DURING THE TIME PERIOD ORS WORKED TO FULFILL ITS DUTIES AND RESPONSIBILITIES UNDER S.C. CODE § 58-4-50 TO REVIEW, INVESTIGATE AND MAKE APPROPRIATE RECOMMENDATIONS TO THE COMMISSION WITH RESPECT TO THE RATES PROPOSED TO BE CHARGED BY THE UTILITY.**

**A.** ORS’s conduct was consistent with its statutory duties to review, investigate and make recommendations to the Commission in accordance with the ORS mission to represent the concerns of the using and consuming public with respect to public utility services, regardless of the class of customer, and preservation of continued investment in and maintenance of utility facilities so as to provide reliable and high-quality utility services. The ORS Audit Department interacted with PUI and its representatives in the same manner and fashion as the department would all other utilities during a rate case proceeding. ORS witness Hipp responds in more detail to PUI’s assertions.

**Q. DO YOU ATTEMPT TO ADDRESS THE COMPANY’S ASSERTIONS THAT THE RETURN OF THE REGULATORY LIABILITY FOR EXCESS CORPORATE**

**INCOME TAX EXPENSE CONSTITUTES RETROACTIVE AND SINGLE  
EXPENSE RATEMAKING AS PART OF YOUR SURREBUTTAL TESTIMONY?**

**A.** No. The Company's claims and assertions that the return of excess corporate income tax expense constitutes retroactive and single expense ratemaking are legal, not accounting, arguments put forth by the Company's witnesses. I do not address these legal arguments as I am not a lawyer.

**Q. DID ORS UPDATE ITS CALCULATION OF THE REGULATORY LIABILITY  
FOR EXCESS CORPORATE FEDERAL INCOME TAX EXPENSE?**

**A.** Yes. I filed revised direct testimony and exhibits on June 5, 2020 to correct the calculation of the regulatory liability for excess corporate federal income tax expenses collected by PUI as a result of the TCJA. I noted an error in ORS's calculation of excess corporate federal income tax expenses on Exhibit DFS-2 due to a misinterpretation of Commission Order No. 2018-155 regarding operating expenses.

**Q. PLEASE RESPOND TO COMPANY WITNESS DADAY'S REBUTTAL  
TESTIMONY RELATED TO ORS'S CALCULATION OF THE REGULATORY  
LIABILITY FOR EXCESS CORPORATE FEDERAL INCOME TAX EXPENSE.**

**A.** Company witness Daday states in his rebuttal testimony "ORS uses the amounts listed in the allowed figures for the 2017 test year from the previous PUI rate case (Commission Order No. 2018-155) for expenses and revenue in order to calculate the potential "benefit" to be returned to ratepayers for the period of January 1, 2018 to the expected date of this rate order, August 6, 2020."<sup>1</sup> Company witness Daday is not completely accurate in his statement. To clarify, to calculate the excess corporate federal

<sup>1</sup> Company witness Daday Rebuttal Testimony page 15, line 21 through page 16, line 3.

1 income tax expense for the period January 1, 2018 to August 6, 2020 (Revised Exhibit  
2 DFS-2) ORS was required to rely upon Commission Order Nos. 2015-153 and 2018-155  
3 because Commission Order No. 2018-155 did not become effective until March 7, 2018.  
4 Therefore, ORS relied upon prior Commission Order No. 2015-153 to calculate the excess  
5 corporate federal income tax expense for the time period January 1, 2018 to March 6, 2018.

6 **Q. PLEASE EXPLAIN WHY ORS DOES NOT RELY UPON ACTUAL REVENUES**  
7 **EARNED AND ACTUAL EXPENSES INCURRED TO CALCULATE THE**  
8 **REGULATORY LIABILITY FOR EXCESS CORPORATE INCOME TAX**  
9 **EXPENSE.**

10 **A.** Company witness Daday states in his rebuttal testimony “to correctly calculate this  
11 “benefit,” actual revenues earned and actual expenses incurred during the time period in  
12 question should be included and the reduced tax liability determined using the 34% (old)  
13 and 21% (new) federal income tax rate. This calculation, to the estimated date of this order  
14 (August 6, 2020) produces a potential refund amount of only \$347,065 as demonstrated in  
15 my MD Rebuttal Exhibit 7.”<sup>2</sup> ORS does not agree the actual revenues and expenses as  
16 included on MD Rebuttal Exhibit 7 should be used for the calculation of the regulatory  
17 liability for excess federal corporate income tax expense for PUI for three (3) reasons.

18 First, the actual revenues and expenses on MD Rebuttal Exhibit 7 have not been  
19 audited or verified by ORS and are not the same revenues and expenses reflected in  
20 Commission Order Nos. 2015-153 and 2018-155. Customer rates approved by the  
21 Commission were designed to provide the Company with full recovery of a 34% federal  
22 corporate income tax rate. The actual revenues and expenses experienced by the Company

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<sup>2</sup> Company witness Daday Rebuttal Testimony page 16, lines 7-12.

1 after those customer's rates went into effect were likely different than what is reflected in  
2 the Commission orders. This is a normal timing difference characteristic in ratemaking.

3 Second, it appears that some of the actual expenses on MD Rebuttal Exhibit 7 do  
4 not reflect typical adjustments made in a rate case for ratemaking purposes. For example,  
5 interest expense listed on MD Rebuttal Exhibit 7 is reflected as \$4,295,499 for the 12-  
6 Months Ended December 31, 2018, \$3,895,176 for the 12-Months Ended December 31,  
7 2019, and \$3,128,919 (prorated) for the 12-Months Ended December 31, 2020. By  
8 comparison, the Company's application included an adjusted synchronized interest  
9 expense of \$2,330,675, ORS's adjusted synchronized interest expense in this docket is  
10 \$2,060,441 (Exhibit CLS-1), and the amount of synchronized interest expense included in  
11 Commission Order No. 2018-155, PUI's last rate case, was \$1,779,510.

12 Third, as indicated in my revised direct testimony, many timing differences exist  
13 between when the Company recovers income tax expense from customers through rates  
14 and when the Company pays taxes to the United States Internal Revenue Service ("IRS").  
15 For example, the use of straight line for calculating depreciation expense for ratemaking  
16 purposes as compared to the use of accelerated depreciation for calculating depreciation  
17 expense for IRS purposes, results in different income tax calculations. The use of straight  
18 line spreads out depreciation expense over the expected life of the asset as compared to  
19 accelerated depreciation which allows a Company to write-off the asset for tax purposes  
20 all at one time or over a shorter period of time. Differences such as these create the timing  
21 differences between when a Company recovers income tax expense from customers  
22 through rates and when the Company pays those taxes to the IRS.

1 In conclusion, the calculation of the regulatory liability for excess corporate federal  
2 income taxes should be based on revenues and expenses that have been audited, considered  
3 by the Commission, and used by the Commission in the determination and setting of rates  
4 to be charged to customers through its Orders. To do differently would be inaccurate.

5 **Q. DID THE COMPANY ESTABLISH A REGULATORY LIABILITY ON ITS BOOKS**  
6 **AND RECORDS TO ACCOUNT FOR THE EXCESS CORPORATE FEDERAL**  
7 **INCOME TAXES?**

8 **A.** Company witness Daday states in his rebuttal testimony “the Company did  
9 establish a liability, although not denominated a regulatory liability in its general ledger,  
10 for potential refunds to customers related to the TCJA in the event that the Commission  
11 rejects the Company’s retroactive ratemaking and single expense ratemaking arguments.”<sup>3</sup>  
12 ORS was unable to verify if the Company has established a liability related to the excess  
13 corporate federal income taxes. An audit request sent by ORS to PUI requested PUI to  
14 identify the regulatory liability account used to track and defer the effects of the TCJA and  
15 where the account was located on the Company’s balance sheet. The Company provided  
16 ORS with a similar response to Company witness Daday’s rebuttal testimony assertions.  
17 However, the Company did not provide the account for the liability such that ORS could  
18 review or verify the accuracy.

19 **Q. WHAT METHOD WAS USED IN THE CALCULATION OF THE REGULATORY**  
20 **LIABILITY FOR EXCESS CORPORATE FEDERAL INCOME TAX EXPENSE IN**  
21 **THE MOST RECENT RATE CASE BEFORE THE COMMISSION?**

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<sup>3</sup> Company witness Daday Rebuttal Testimony page 17, lines 4 – 7.

1     **A.**           The most recent rate case before the Commission was Blue Granite Water  
2           Company (“BGWC”), Docket No. 2019-290-WS. The method used by BGWC to calculate  
3           the regulatory liability for excess corporate income tax expense in Docket No. 2019-290-  
4           WS is the same methodology proposed by ORS in this docket. BGWC’s calculations relied  
5           upon the revenues and expenses in Docket No. 2015-199-WS, set by Commission Order  
6           No. 2015-876, to determine the cumulative change in net income for return when using a  
7           21% federal income tax rate, as compared to the 35% income tax rate used in the order.  
8           The calculation resulted in a regulatory liability for excess corporate income tax expense  
9           of \$335,713.

10           In Order No. 2020-306, the Commission adopted BGWC’s proposal to initiate a  
11           one-time credit to each customer’s water and sewer service account to return the regulatory  
12           liability which was accumulated by BGWC between January 1, 2018 and June 28, 2018 in  
13           the amount of \$335,713.

14     **Q.     PLEASE SUMMARIZE ORS’S RECOMMENDATION REGARDING THE**  
15           **REGULATORY LIABILITY FOR EXCESS CORPORATE INCOME TAX**  
16           **EXPENSE?**

17     **A.**           ORS recommends a regulatory liability in the amount of (\$2,001,430) be recorded  
18           by PUI to reflect compliance with Commission Order No. 2018-308, which required water  
19           and wastewater utilities with operating revenues greater than \$250,000 to track and defer  
20           in a regulatory liability account the tax effects resulting from the TCJA beginning January  
21           1, 2018. As result of the TCJA, there was a decrease in the corporate federal income tax  
22           rate applicable to PUI from 34% to 21%. The regulatory liability reflects the impact of the  
23           TCJA related to the reduction in tax expenses due to the corporate federal income tax rate

change. ORS recommends the regulatory liability be refunded to current customers over three (3) years through a TCJA Decrement Rider which is discussed in ORS witness Hunnell's revised direct testimony.

**Q. PLEASE RESPOND TO COMPANY WITNESS DADAY'S STATEMENTS REGARDING THE REGULATORY TREATMENT OF OVERHEAD EXPENSES IN THE PRIOR PUI AND PRIOR PALMETTO WASTEWATER RECLAMATION ("PWR") RATE CASES.**

**A.** Company witness Daday states in his rebuttal testimony "[i]n that proceeding, the Company simply did not include bonuses in its calculation of corporate overhead. So, no bonuses were 'removed' by the Company and it never 'designated the bonuses as nonallowable.'" <sup>4</sup> Company witness Daday's statement is responding to ORS witness Seale's direct testimony which states "the companies voluntarily removed all bonuses and designated the bonuses as nonallowable." <sup>5</sup> PUI's witness Daday is correct that the Company did not request recovery of the bonuses in its last rate case. After further review, I found that bonuses in PUI's last rate case proceeding were not included in its overhead adjustment, and the Company never designated those bonuses as nonallowable, but did include them as part of the excluded items section in the calculation of the Company's overhead adjustment. However, in the prior PWR rate case, PWR specifically removed all bonuses and designated them as nonallowable when calculating its overhead adjustment. ORS witness Seale's direct testimony related to both PUI's and PWR's treatment of employee bonuses in their prior most recent rate cases provides important historical context for the rulings made by the Commission in those rate cases. ORS reviews trends through

<sup>4</sup> Company witness Daday Rebuttal Testimony page 4, line 20 through page 5, line 1.

<sup>5</sup> ORS witness Seale Direct Testimony page 9, lines 8 – 9.



1        analytical reviews and compares expenses using the Company's and affiliated Companies'  
2        current and prior rate cases. The review for the current PUI case indicated bonuses had  
3        increased and were included for recovery by the Company as part of its overhead  
4        adjustment, which expanded ORS's investigation process of the bonuses the Company  
5        sought for recovery.

6        **Q.        PLEASE RESPOND TO COMPANY WITNESS DADAY'S STATEMENT THAT**  
7        **"MS. SEALE'S ASSERTION THAT THE BONUSES ARE NOT KNOWN AND**  
8        **MEASURABLE IS ALSO INCORRECT."**<sup>6</sup>

9        **A.**        The Company's response to ORS's First Request for Production of Books and  
10       Records and Other Information #1.37 ("#1.37") (MD Rebuttal Exhibit 6, page 1) stated  
11       that the "the annual bonus amount can vary within the allowed range base[d] on that year's  
12       performance." In addition, based on the Company's response to ORS Audit Request #16-  
13       1 (MD Rebuttal Exhibit 6, page 16) the Company has steadily increased its bonuses from  
14       \$69,608 in 2015 to \$187,000 in 2019. However, the Company's response to ORS Audit  
15       Request #12-1 (MD Rebuttal Exhibit 6, page 11) shows 2018 bonuses of \$251,500 and  
16       total test year bonuses, included by the Company in overhead expenses, of \$311,500.

17       The total bonuses included in overhead expenses of \$311,500, requested by the  
18       Company to be included in rates, "includes accruals crossing two calendar years" as stated  
19       in the Company's response to ORS Audit Request #8-3 (MD Rebuttal Exhibit 6, page 3).  
20       Therefore, ORS concluded based on the information provided by the Company that the  
21       actual test year bonuses paid by the Company are not known and measurable.

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<sup>6</sup> Company witness Daday Rebuttal Testimony page 7, lines 18 – 19.

**Q. IS COMPANY WITNESS DADAY CORRECT IN HIS STATEMENT THAT SUGGESTS ORS ASKED FOR INFORMATION IT ALREADY POSSESSED?**

**A.** No. Company witness Daday states in his rebuttal testimony “Ms. Seale omits the fact that ORS Audit Request #8 also asked if the Company paid any incentive compensation in the test year even though that information had been supplied in our response to Request #1.37. Nonetheless, the information was provided again.”<sup>7</sup> The scope of ORS’s follow-up request in ORS Audit Request #8-3 (MD Rebuttal Exhibit 6, page 2) was an attempt to further clarify the Company’s response to #1.37 (MD Rebuttal Exhibit 6, page 1). ORS’s #1.37 requested the Company to “state Palmetto’s practices and procedures for employee and officer bonuses.” The Company’s response to #1.37 provided a narrative answer to the question asked in #1.37. ORS Audit Request #8-3 (MD Rebuttal Exhibit 6, page 2) was sent to the Company to obtain additional more specific data and information. The scope and number of requests and follow up requests from ORS for information from PUI were a result of ORS attempting to further clarify and determine if the Company’s calculations regarding incentive compensation should be included for recovery from its customers.

**Q. PLEASE DISCUSS ORS’S REVIEW AND INVESTIGATION OF THE COMPANY’S SUPPORTING DOCUMENTATION RELATED TO EMPLOYEE AND OFFICER BONUSES.**

**A.** ORS did not receive bonus supporting documentation for each of the Company’s employees to justify employee bonuses should be included in expenses used in determining the total net income for return for the Company. Although the Company’s response to

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<sup>7</sup> Company witness Daday Rebuttal Testimony page 10, lines 1 – 3.

1 #1.37 was informative, ORS sought clarification which led to requests for additional  
2 information. ORS issued ORS Audit Request #8-4 to seek further clarification and attempt  
3 to verify the Company's earlier response to #1.37.

4 In the Company's response to #1.37 (MD Rebuttal Exhibit 6, page 1), the Company  
5 referred to "the bonus policy" in the second paragraph. In ORS Audit Request #12, ORS  
6 requested, among other things, a copy of the Company's written Annual Performance  
7 Bonus Policy referenced in the Company's response to #1.37. The Company responded  
8 that no formal policy existed. ORS Audit Request #12 and the Company's response is  
9 attached to Company witness Daday's rebuttal testimony as Rebuttal Exhibit 6, pages 5  
10 and 6.

11 The Company also included in its response to ORS Audit Request #12.3 a detailed  
12 breakdown of key bonus factors for finance employees, the operations department and all  
13 three operations executives. The breakdown of key bonus factors indicated the Company's  
14 key bonus factors are broad, not specific to individual employees, and do not contain a list  
15 of goals for employees, achievement criteria and whether those goals were met during the  
16 review period by each employee. The Company's response to ORS Audit Request #12-3  
17 also indicated that "all other employees received a small Christmas bonus." It is ORS's  
18 position the Company's key bonus factors are not sufficient for ORS to determine PUI's  
19 customers received a clear benefit as a result of PUI's bonuses.

20 On April 15, 2020, the Company provided ORS an additional response to ORS  
21 Audit Request #12 (MD Rebuttal Exhibit 6, pages 7 and 8). The information, in response  
22 to ORS Audit Request #12, provided additional information related to the managers in the  
23 accounting group and detailed the financial goal, achievement of goal, and

1 accomplishments for four (4) of the managers, while it only listed the accomplishments for  
2 one (1) manager. The financial goal for each of the four (4) managers was to “achieve  
3 NPMU<sup>8</sup> corporate EBITDA<sup>9</sup> of \$10.4 million for 2018.” However, the “Achievement of  
4 Goal” section stated “as of October 31, 2018, NPMU consolidated EBITDA is forecasted  
5 at \$10.5 million.” It appears based on the information provided to ORS the Company paid  
6 the four (4) accounting managers bonuses based on the forecasted EBITDA of \$10.5  
7 million as of October 31, 2018 and did not update the achievement of goal section for the  
8 actual EBITDA achieved by NPMU for 2018.

9 **Q. HAS ORS’S POSITION REGARDING BONUSES CHANGED AFTER READING**  
10 **PUI WITNESS DADAY’S REBUTTAL?**

11 **A.** No. The Company has not provided additional detailed documentation or rationale  
12 in its rebuttal testimony to change ORS’s recommendation to disallow recovery of  
13 \$334,687 in bonuses and associated taxes and benefits.

14 **Q. WILL ORS REVIEW AND VERIFY ADDITIONAL RATE CASE EXPENSES IF**  
15 **REQUESTED BY THE COMMISSION?**

16 **A.** Yes. ORS recognizes the Company has incurred and will continue to incur expenses  
17 up to and through the hearing. ORS does not object to an additional update to rate case  
18 expenses, subject to ORS’s verification, as part of ORS’s proposed order.

19 **Q. WILL YOU UPDATE YOUR SURREBUTTAL TESTIMONY BASED ON**  
20 **INFORMATION THAT BECOMES AVAILABLE?**

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<sup>8</sup> Ni Pacolet Milliken Utilities

<sup>9</sup> Earnings Before Interest, Taxes, Depreciation and Amortization

1     **A.**             Yes. ORS fully reserves the right to revise its recommendations via supplemental  
2             testimony should new information not previously provided by the Company, or other  
3             sources, becomes available.

4     **Q.       DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

5     **A.**             Yes, it does.